Box 3

HOW HAVE GOVERNMENTS' BANK RESCUE PACKAGES AFFECTED INVESTORS' PERCEPTIONS OF CREDIT RISK?

The insolvency of Lehman Brothers in mid-September 2008 prompted a re-evaluation of the risks embedded in the financial system. It also became increasingly evident that the financial market turbulence would have substantial fallout effects on the real economy. The risk of a melt-down of financial institutions and a sudden transformation of the "financial market turbulence" into an outright "financial and economic crisis" caused governments to embark on bank rescue packages, which played a central role within a broader set of policy measures aimed at supporting financial and economic stability. Between late September and mid-October 2008, several countries in the euro area made available substantial amounts of capital and guarantees in support of their banks.

The purpose of this box is to examine two dimensions of the financial market response to these events. First, the box compares how the announcement of broad-based bank rescue packages affected investors' perceptions of public sector and private sector credit risk. Second, the box shows that, for many euro area countries, the long-term government bond yield spreads (over Germany) have increased since September last year. It is reasonable to assume that the capital injections and guarantees provided by governments to the financial sector, coupled with the adverse effects of the economic downturn on their fiscal positions, prompted investors to discriminate among sovereign borrowers on the basis of the soundness of their public finances.

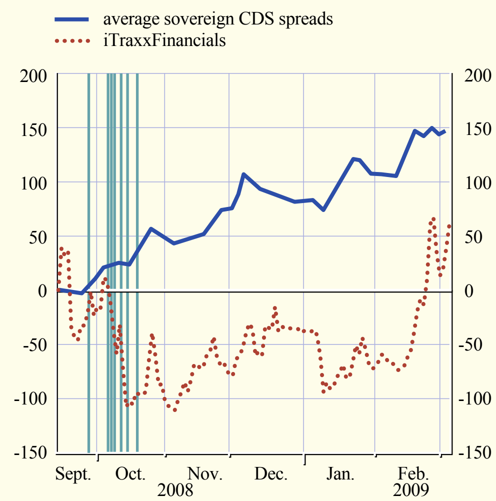
Investors' credit risk perceptions

In order to gauge changes in investors' credit risk perceptions, developments in credit default swap (CDS) spreads are commonly used. A CDS is a contract in which a "protection buyer" pays a periodic premium to a "protection seller" and, in exchange, receives a payoff if the reference entity (a firm or a government issuer) experiences a "credit event", for example, a failure to make scheduled interest or redemption payments on debt instruments (typically bonds or loans).

In order to assess the extent to which the bank rescue packages announced by various euro area countries have altered the market's perception of the credit risks for the parties involved, Chart A depicts the movements in sovereign CDS spreads and CDS spreads for iTraxx financials, the latter representing the CDS spreads of large European financial institutions. The vertical bars in the chart indicate the dates on which major rescue packages were put in place by ten euro area countries (between 29 September and 20 October). As can be seen from the chart, the packages led to sharp declines in euro area banks' CDS spreads (as approximated by the iTraxx financial spread). At the same time, the rescue packages resulted in a higher risk of sovereign default. Taking a longer perspective, the iTraxx financials CDS spreads stood, at the end of February, at levels somewhat below those recorded before the rescue packages were announced, while sovereign spreads continued to widen. This suggests that, all in all, the broad-based rescue packages have alleviated some credit risk in the banking sector and have brought about an immediate and lasting transfer of credit risk from the private to the public sector.

Chart A Cumulative changes in euro area sovereign CDS spreads and iTraxx financial CDS spreads since 15 September 2008

(basis points)



Sources: Datastream and ECB calculations.
Note: The vertical bars indicate the dates in the autumn of 2008 on which major bank rescue packages were announced in the euro area countries, namely 29 September (Ireland), 7 October (Spain), 8 October (Italy), 9 October (the Netherlands), 12 October (Portugal), 13 October (Austria, Germany and France), 15 October (Greece) and 20 October (Finland).

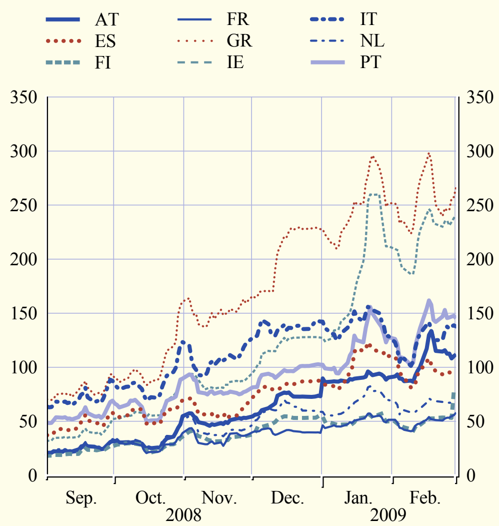
Increase in long-term government bond yield spreads

In the wake of the difficulties experienced in the financial sector as from mid-September 2008, economic activity has deteriorated further. This contributed to a sharp and broad-based worsening of fiscal positions across euro area countries, also because many euro area governments set large fiscal stimulus packages in motion to counter the fall in economic activity. This is reflected in higher forecast debt and deficit ratios across euro area countries. According to the latest information available (the European Commission's January 2009

Interim Forecasts), budget deficits above the reference value of 3% of GDP are expected for several euro area countries in 2009 and in many cases this situation will not be reversed in 2010. Likewise, the debt-to-GDP ratio is forecast to also increase, reflecting in particular the governments' interventions in support of the banking sector (e.g. bank recapitalisations).

Chart B Ten-year government bond yield spreads vis-à-vis Germany

(basis points)



Sources: Datastream and ECB calculations.

The deteriorating fiscal outlook, together with lower growth prospects, may signal to investors that there is a potential need for additional sovereign borrowing and put upward pressure on long-term interest rates.[1] Chart B depicts the developments in the ten-year government bond spread of the euro area countries given in Chart A vis-à-vis Germany as from September 2008. Countries that have experienced the largest increase in their sovereign bond spreads seem to be those that have entered the crisis from an unfavourable fiscal position and those whose situation is expected to deteriorate sharply in the near future. In fact, investors seem to discriminate among sovereign borrowers, partly on the basis of the soundness of the country's public finances. It should also be noted that sovereign bond yield spreads are also affected by other factors, for example, by downgrades of a country's credit rating and differences in the liquidity of the underlying bonds.

This box has shown that – in the eyes of investors – euro area countries' bank rescue packages, as announced in September and October 2008, have resulted in a transfer of credit risk from the private to the public sector. Furthermore, together with weakening fiscal positions in the wake of the economic crisis, the bank rescue packages seem to have contributed to a sharp widening of intra-euro area government bond spreads, in particular for member countries with weaker fiscal positions. Looking ahead, it is important that governments return to sound fiscal positions as soon as possible in order to maintain the public's trust in the sustainability of public finances.

1 See Box 2, entitled "Recent widening in euro area sovereign bond yield spread", in the November 2008 issue of the Monthly Bulletin.